

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:F:LI:POSTF-141597-02

HNAdams

date: November 1, 2002

to: Team Manager Stephen P. Lubiak, LMSB Division Group 1461

from: Associate Area Counsel (Financial Services)

CC:LM:F:LI

subject: E&P Issue - [REDACTED] Corp. EIN [REDACTED]
[REDACTED] EIN [REDACTED]

This memorandum responds to your request for assistance dated July 31, 2002. This memorandum should not be cited as precedent.

ISSUES

1. Should estimated but unpaid remediation expenses and asserted tort claims be taken into account in the calculation of the earnings and profits of [REDACTED] Corp. as of [REDACTED]? The answer to this question is relevant to the taxability of a proposed distribution by [REDACTED] to its shareholders. UIL No. 312.00-00.

2. Should the Service agree to enter into a closing agreement with [REDACTED] and [REDACTED] Corp. fixing the amount of the earnings and profits of [REDACTED] Corp. as of [REDACTED]? UIL No. 7121.00-00.

CONCLUSIONS

1. Estimated but unpaid remediation expenses and asserted tort claims should not be taken into account in the calculation of the earnings and profits of [REDACTED] as of [REDACTED].

2. We recommend that LMSB Division decline to enter into a closing agreement with [REDACTED] and [REDACTED] Corp. fixing the amount of the earnings and profits of [REDACTED] Corp. as of [REDACTED].

FACTS

Our understanding of the facts is based on the [REDACTED] letter from the taxpayers that you provided with your request for assistance. [REDACTED] Corp. (sometimes referred to herein as "the company") was incorporated on [REDACTED] and was a C corporation until [REDACTED]. Historically, [REDACTED] Corp. owned and operated [REDACTED]

[REDACTED] Corp. was incorporated on [REDACTED], and elected to be an S corporation as of [REDACTED]. [REDACTED] was incorporated on [REDACTED] and elected to be an S corporation effective for its initial tax year ended [REDACTED].

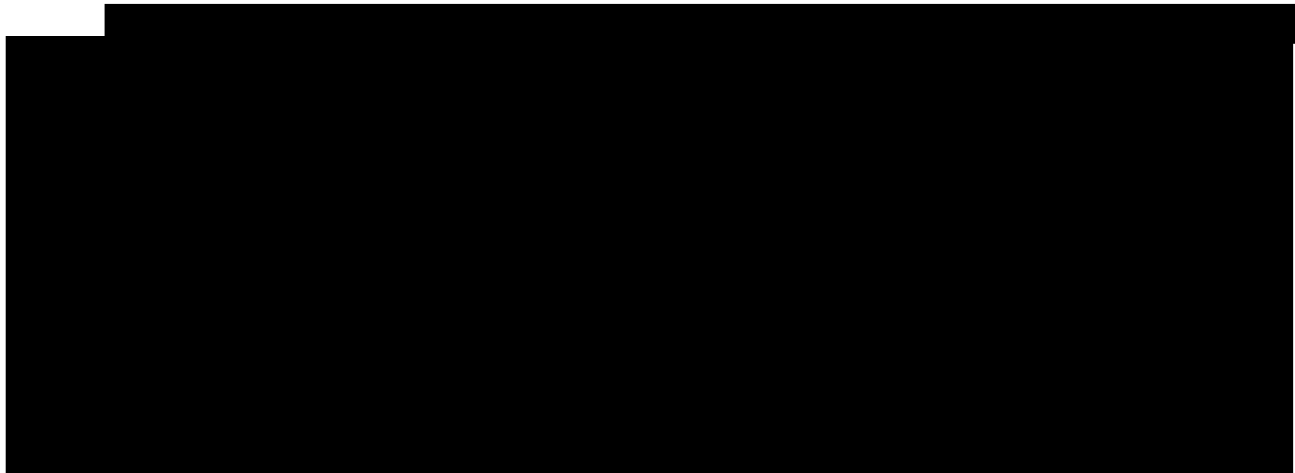
On [REDACTED] all of the shareholders of [REDACTED] Corp. exchanged their ownership interests in [REDACTED] Corp. for proportionate interests in [REDACTED]. As a result, [REDACTED] Corp. became a wholly-owned subsidiary of [REDACTED] elected on [REDACTED] to treat [REDACTED] Corp. as a Qualified Subchapter S Subsidiary.

As of [REDACTED], the accumulated earnings and profits of [REDACTED] Corp. were approximately \$[REDACTED]. Its earnings and profits for the year ended [REDACTED] were approximately \$[REDACTED]. On [REDACTED] [REDACTED] Corp. acquired a portion of its then outstanding stock from a shareholder for about \$[REDACTED] in redemption of the shareholder's interest. In addition, [REDACTED] Corp. distributed approximately \$[REDACTED] to its remaining shareholders. According to the taxpayer, the foregoing transactions resulted in [REDACTED] Corp. having accumulated earnings and profits at [REDACTED] of approximately \$[REDACTED]:

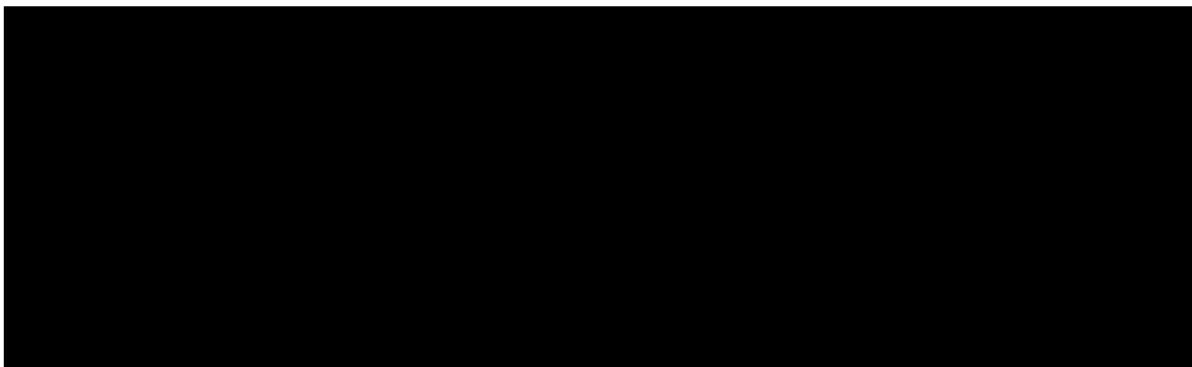
Accumulated E&P as of [REDACTED]	\$ [REDACTED]
E&P for year ended [REDACTED]	[REDACTED]
	[REDACTED]

Redemption
Distribution
Balance per taxpayer

\$



In its [REDACTED] letter, the taxpayers state as follows:



¹ The taxpayer's letter does not provide enough facts to determine whether E&P is properly reduced by the entire \$ [REDACTED] paid in redemption. The reduction is correct if the redemption was treated as a distribution of property under section 301. See I.R.C. § 312(a). However, if the redemption was treated as a redemption to which section 302(a) or 303 apply, then the amount of the reduction would be limited to the redeemed stock's "ratable share" of the earnings and profits of [REDACTED] Corp. See I.R.C. § 312(n)(7).

LEGAL ANALYSIS1. Existence of Earnings and Profits

Under current law, S corporations generally do not generate current earnings and profits. I.R.C. § 1371(c). However, an S corporation can have accumulated earnings and profits from, as is relevant here, a carryover from years in which it was a C corporation (see Toberman v. Commissioner, T.C. Memo. 2000-221; Cameron v. Commissioner, 105 T.C. 380, 384 (1995), aff'd, 111 F.3d 593 (8th Cir. 1997)) or as the result of certain other transactions that involve the application of subchapter C to S corporations. See I.R.C. § 1371(c)(2); see also Eustice & Kuntz, Federal Income Taxation of S Corporations, § 8.04[8][b], at 8-76 (4th ed. 2001).

Under the foregoing rules, the earnings and profits that [REDACTED] Corp. had accumulated through the end of its existence as a C corporation on [REDACTED] carried over to it when it converted to an S corporation on [REDACTED]. Pursuant to the interplay between the rules governing the effect of electing to treat a subsidiary as a Qualified Subchapter S Subsidiary and the rules governing the treatment of earnings and profits of a subsidiary that is liquidated into its parent, [REDACTED] succeeded to the earnings and profits of [REDACTED] Corp. Treasury regulation 1.1361-4(a)(2)(i) states that:

[i]f an S corporation makes a valid Qsub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation. Except as provided in paragraph (a)(5) of this section, the tax treatment of the liquidation or of a larger transaction that includes the liquidation shall be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

That regulation is consistent with Code section 1371(c)(2) which provides that "[i]n the case of any transaction involving the application of subchapter C to any S corporation, proper adjustment to any accumulated earnings and profits of the corporation shall be made." Code sections 381(a)(1) and 381(c)(2) provide that when a parent receives the assets of a subsidiary in a transaction to which section 332 applies (which, as relevant here, includes the liquidation of an 80 percent owned

subsidiary), then the parent is deemed to have received the earnings and profits of the subsidiary "as of the close of the date of the distribution or transfer * * *." As a result, whatever earnings and profits [REDACTED] Corp. had as of the close of [REDACTED] the date [REDACTED] elected to treat it as a qualified subchapter S subsidiary, carried over to [REDACTED]

2. Impact of Earnings and Profits of Taxability of S Corporation Distributions

If an S corporation has earnings and profits, Code section 1368(c) provides that distributions it makes with respect to its stock are treated in the manner provided by Code section 1368(b) to the extent they do not exceed the S corporation's accumulated adjustments account.² The portion of the distribution that exceeds the accumulated adjustments account is then treated as a dividend to the extent that it does not exceed the S corporation's accumulated earnings and profits. I.R.C. § 1368(c)(2). Finally, any balance is treated in the manner provided by Code section 1368(b). I.R.C. § 1368(c)(3). Section 1368(b) provides that distributions are excluded from gross income to the extent of the adjusted basis of the stock, and that the amount in excess of basis is treated as gain from the sale or exchange of property.

3. Should the Earnings and Profits of [REDACTED] Corp. as of [REDACTED] Have Been Reduced by Estimated but Unpaid Remediation Expenses and Asserted Tort Claims?

Earnings and profits are computed according to the method of accounting that the taxpayer properly employs. Treas. Reg. § 1.312-6(a); Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, § 8.04[1] (7th ed. 2002).³ As

² That account is intended to measure the corporation's accumulated taxable income that has not been distributed to shareholders. See I.R.C. § 1368(e); Williams v. Commissioner, 110 T.C. 27, 30 (1998).

³ The computation of earnings and profits "is based upon reasonable accounting concepts that take into account the economic realities of corporate transactions as well as those resulting from the application of tax law." Rev. Rul. 75-515,

██████████ Corp. is an accrual method taxpayer, it is proper to look to the standards that apply to that method of accounting to determine whether its earnings and profits should be reduced by estimated and unpaid remediation expenses and asserted tort claims.⁴

Under the accrual method of accounting, a liability is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which:

(1) all the events have occurred that determine the fact of the taxpayer's liability,

(2) the amount of the liability can be determined with reasonable accuracy, and

(3) economic performance has occurred with respect to the liability.

I.R.C. § 461(h); Treas. Reg. § 1.446-1(c)(2)(ii); and Treas. Reg. § 1.461-1(a)(2). The first two requirements are referred to as the all events test. The third requirement is referred to as the economic performance requirement.

Under the all events test, a liability does not accrue as long as it remains contingent. United States v. Hughes Properties, Inc., 476 U.S. 593, 600 (1986) and cases cited therein. To satisfy the all events test, a liability must be "final and definite in amount," must be "fixed and absolute," and must be "unconditional." Id. In other words, a deduction must be deferred until all the events have occurred that make it fixed and certain. Id. at 600-01. Consistent with that rule, a taxpayer is not entitled to a deduction for a liability that it

1975-2 C.B. 117, 118.

⁴ The regulations illustrate the rule that earnings and profits are computed according to the method of accounting that the taxpayer properly employs by providing the example that "[g]ains and losses within the purview of section 1002 are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section." Treas. Reg. § 1.312-6(a).

is contesting in court and that remains unpaid. Dixie Pine Products Co. v. Commissioner, 320 U.S. 516, 519 (1944).

Under the economic performance requirement, economic performance with respect to a liability for a tort, breach of contract, or violation of law "occurs as payment is made to the person to whom the liability is owed." I.R.C. §§ Treas. Reg. § 1.461-4(g)(2).

Here the estimated but unpaid remediation expenses and the contested tort claims fail to satisfy those standards. At the outset, the asserted tort claims do not satisfy the all events test because [REDACTED] Corp. had not paid them, and was in fact still contesting them in court, on [REDACTED]. Similarly, the liability of [REDACTED] Corp. for estimated but unpaid remediation expenses was not "final and definite in amount," "fixed and absolute," and "unconditional" on [REDACTED]. Moreover, even if the all events test was satisfied with respect to the estimated but unpaid remediation expenses and the contested tort claims, it is evident that [REDACTED] Corp. had not satisfied the economic performance requirement so as to be entitled to deduct them as of [REDACTED]. As was stated above, [REDACTED] Corp. had not paid the amounts at issue.

Contrary to the taxpayers' position, the issue of whether a distribution is taxable as a dividend does not hinge on whether the distribution would be legal under state law. See Commissioner v. Gross, 236 F.2d 612 (2d Cir. 1956), aff'd, 23 T.C. 756 (1955). In Commissioner v. Gross, the United States Court of Appeals for the Second Circuit held that a distribution that exceeded a corporation's earnings and profits was not taxable as a dividend even though it was allowable under state law.

4. Should the Service Agree to Enter into a Closing Agreement with [REDACTED] and [REDACTED] Corp. Fixing the Amount of Earnings and Profits as of [REDACTED]?

The taxpayers' [REDACTED] letter states that the amount of earnings and profits of [REDACTED] Corp. as of [REDACTED] will "determine how much, if any, of a proposed distribution by [REDACTED] to its shareholders (the "Proposed Distribution") will be taxed as a dividend under §301." Given

that the request relates to a distribution that has not yet been made, the taxpayers are in effect seeking an advance ruling from the Service on the amount of the earnings and profits. In these circumstances, we recommend that you decline the taxpayers' request to enter into a closing agreement on the amount of earnings and profits of [REDACTED] Corp. as of [REDACTED].

Any questions about this advice should be directed to the undersigned at (516)688-1737.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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